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Angel Investors, LLC, a Utah limited liability company, suing derivatively on behalf of XanGo LLC v. Aaron Garrity, Bryan Davis, Gary Hollister, Gordon Morton, Joseph Morton, and Kent Wood : Reply Brief

Utah Supreme Court

IN THE UTAH SUPREME COURT

ANGEL INVESTORS, LLC, a Utah limited liability company, **suing derivatively on behalf of XanGo LLC,**	)	
Appellant,	)	Case No. 20080111-SC
v.	)	
AARON GARRITY, BRYAN DAVIS, GARY HOLLISTER, GORDON MORTON, JOSEPH MORTON, and KENT WOOD,	)	
Appellees.	)	

REPLY BRIEF OF APPELLANT

APPEAL FROM A FINAL JUDGMENT OF THE FOURTH JUDICIAL DISTRICT COURT IN UTAH COUNTY THE HONORABLE FRED D. HOWARD

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ARGUMENT

I. THE PROPER STANDARD OF REVIEW FOR THE ISSUES IN THIS APPEAL IS CORRECTNESS, NOT ABUSE OF DISCRETION

Because the parties to this appeal disagree about the appropriate standard of review for each of the Issues, Angel Investors, LLC ("Angel") has included in its Reply Brief this more in-depth discussion of the standards of review.

A. A Court's Grant of a Rule 12(b)(1) Motion to Dismiss Without Allowing Discovery is Reviewed for Correctness, Not Abuse of Discretion

While the Defendants may be correct that the denial of a Rule 56(f) motion made in response to a motion for summary judgment is reviewed using an abuse of discretion standard, *see* Brief of Appellees at 3, this is not the appropriate standard of review when the request for additional discovery is made in response to a Rule 12(b)(1) motion to dismiss. Here, the appropriate standard is correctness. *See* Brief of Appellant at 1-2.

Although Angel's request for additional discovery was initially labeled as a motion pursuant to Rule 56(f), the label a party uses to name its motion is not dispositive. *Canfield v. Layton City*, 2005 UT 60, ¶ 6 n.1, 122 P.3d 622. Rather, as discussed in more detail below, the court considers the content and context of the motion in order to determine the motion's true nature. *See id.* Here, the content and context of the motion reveal that Angel's request for additional discovery was made in response to a Rule 12(b)(1) motion to dismiss, not a Rule 56 motion for summary judgment, and was in fact made so early in the litigation that no discovery had yet been conducted. *See* Brief of

Appellant, Addendum E at ¶¶ 4-5. Thus, it is not appropriate to review the court's denial of Angel's discovery request pursuant to the standards of Rule 56.

Instead, the standards of Rule 12(b)(1) must apply, and a dismissal pursuant to Utah R. Civ. P. 12(b)(1) for lack of subject matter jurisdiction is reviewed for correctness. *Canfield*, 2005 UT 60 at ¶ 6 n.1. The essential consideration here is whether the district court properly granted the motion to dismiss when it considered affidavits attached in support of the motion but denied Angel the opportunity to conduct the discovery necessary to rebut those affidavits. Without this discovery, Angel could not effectively respond to the motion to dismiss.

The appropriate standard of review for this issue is not abuse of discretion, but correctness.

B. A Court's Determination of a Derivative Plaintiff's Standing under Utah R. Civ. P. 23.1 is Reviewed for Correctness

Although Angel and Defendants agree that the district court granted the motion to dismiss because it determined that Angel lacked standing under Rule 23.1 of the Utah Rules of Civil Procedure, the parties disagree as to the standard of review that should be applied to that determination. *Compare* Brief of Appellant at 1-2 (advocating a correctness standard of review) *with* Brief of Appellees at 1-2 (advocating an abuse of discretion standard of review). Utah law supports Angel's position.

Under Utah law, the determination of whether a derivative plaintiff has standing under Rule 23.1 is primarily a question of law, which is reviewed for correctness, not abuse of discretion. *See LeVanger v. Highland Estates Properties Owners Assoc.*, 2003

UT App. 377, ¶ 8, 80 P.3d 569 (reviewing a Rule 23.1 standing determination and stating that the question of whether a party has standing is primarily a question of law); *cf.* Brief of Appellees at 1-2 (relying on cases from the Sixth and Ninth Circuits, as well as the Wisconsin Court of Appeals). Even the district court in its Ruling recognized that "[t]he determination of whether a party has standing 'is primarily a question of law, although there may be factual findings that bear on the issue.'" Brief of Appellant, Addendum A at 6 (quoting *LeVanger*, 2003 UT App. 377 at ¶ 8).

In *LeVanger*, the Utah Court of Appeals reviewed the determination of a derivative plaintiff's standing under Rule 23.1, and explained:

> [T]he question of whether a given individual or association has standing to request a particular relief is primarily a **question of law**, although there may be factual findings that bear on the issue. We will review such factual determinations made by a trial court with deference. *State v. Pena,* 869 P.2d 932, 935-36 (Utah 1994). Because of the important policy considerations involved in granting or denying standing, we will closely review trial court determinations of whether a given set of facts fits the legal requirements for standing, granting minimal discretion to the trial court. *Id.* at 938, 939.

LeVanger, 2003 UT App. 377 at ¶ 8 (quoting *Kearns-Tribune Corp. v. Wilkinson*, 946 P.2d 372, 373-74 (Utah 1997)) (emphasis added).

Significantly, the standing determination being reviewed in *LeVanger* was made at trial following an evidentiary hearing on the issue of standing under Rule 23.1, *LeVanger*, 2003 UT App. 377 at ¶ 6; the use of a less deferential standard of review is even more essential where, as here, the standing determination was made early in the litigation process, without any discovery, upon a Rule 12(b)(1) motion to dismiss for lack of subject matter jurisdiction. Standing is a jurisdictional requirement, *Jones v. Barlow*,

2007 UT 20, ¶ 12, 154 P.3d 808, and a dismissal pursuant to Utah R. Civ. P. 12(b)(1) for lack of subject matter jurisdiction is reviewed for correctness, *see Canfield*, 2005 UT 60 at ¶ 6 n.1, ¶ 10.

The appropriate standard of review for this issue is not abuse of discretion, but correctness.

II. THE DISTRICT COURT ERRED IN GRANTING THE MOTION TO DISMISS WITHOUT ALLOWING ANGEL TIME TO CONDUCT RELEVANT DISCOVERY

The district court granted the motion to dismiss without allowing Angel time to conduct discovery because Angel's discovery request was identified as a Rule 56(f) motion, and the court concluded that Rule 56 was inapplicable to Rule 12(b)(1) motions to dismiss. *See* Brief of Appellant, Addendum A at 3-4, 6. This denial of discovery was error, however, because it was based on an erroneous interpretation of the law. While it is true that a Rule 12(b)(1) motion is not automatically converted into a summary judgment motion simply because affidavits are attached, *see Wheeler v. McPherson*, 2002 UT 16, ¶ 20, 40 P.3d 632, this principle does not foreclose a plaintiff's request for time to conduct discovery.

In support of its position, Angel cited in its Brief *Coombs v. Juice Works Dev. Inc.*, 2003 UT App. 388, 81 P.3d 769, and *Stuart v. Colorado Interstate Gas Co.*, 271 F.3d 1221 (10th Cir. 2001). Defendants challenge Angel's reliance on these cases, correctly noting that because discovery was allowed in these cases, the courts did not reach the issue of whether it would have been error to deny a request for discovery. *See* Brief of Appellees at 40. But the fact that discovery was allowed in those cases is exactly the

point. Angel cited *Coombs* and *Stuart* because these cases establish that it is not necessary to convert a Rule 12 motion to dismiss into a summary judgment motion in order to consider and ultimately grant a request for time to conduct discovery. Both *Coombs* and *Stuart* involved motions to dismiss under Rule 12 which were **not** converted into summary judgment motions, and yet in both cases, the courts allowed the parties to conduct discovery before ruling on the motions to dismiss. *Coombs*, 2003 UT App. 388 at ¶¶ 7-8 (ruling on a Rule 12(b)(3) motion to dismiss); *Stuart*, 271 F.3d at 1225 (ruling on a Rule 12(b)(1) motion to dismiss).

In the end, Defendants encourage this Court to exalt form over function when they argue that the district court properly denied Angel's request for discovery simply because it was labeled as a Rule 56(f) motion. This argument ignores the fact that the label a party uses to name its motion is not dispositive; despite the parties' interpretation of a motion, the court is free to consider both the content and context of the motion in order to determine the motion's true nature. *See Canfield v. Layton City*, 2005 UT 60, ¶ 6 n.1, 122 P.3d 622.

Moreover, the two cases relied upon by Defendants – *Wheeler v. McPherson* and *Spoons v. Lewis* – simply do not support the position of Defendants or the district court. In both cases, this Court upheld the denial of a plaintiff's Rule 56(f) discovery request made in opposition to a Rule 12(b)(1) motion to dismiss **not** because the request had been made pursuant to Rule 56, but because in each case, the plaintiff had already conceded the essential facts upon which the motion to dismiss was made. Thus, no discovery was needed.

For example, in *Wheeler*, this Court made its holding clear when it stated, "Therefore, **because plaintiffs admit the very facts necessary to dispose of their suit** . . ., we rule that the district court did not err by denying plaintiffs' discovery request." *Wheeler v. McPherson*, 2002 UT 16, ¶ 20, 40 P.3d 632 (emphasis added). And in *Spoons*, this Court noted that the plaintiff had openly admitted the facts upon which the motion to dismiss was based and then stated that under these circumstances, the plaintiff "**therefore cannot complain** that the district court's treatment of the motion prevented her from rebutting the evidence." *Spoons v. Lewis*, 1999 UT 82, ¶ 5, 987 P.2d 36 (emphasis added).

Unlike the plaintiffs in *Wheeler* and *Spoons*, however, Angel has not admitted the essential facts upon which the Defendants' motion to dismiss was made, and the district court's denial of Angel's motion for time to conduct discovery prevented Angel from rebutting the evidence outside the pleadings which was considered by the court. Defendants presented, and the district court considered, nineteen affidavits in support of the motion to dismiss, and without the opportunity to conduct discovery or to create a record of any kind, Angel was unable to rebut this evidence or "present by affidavit facts essential to justify" its position. *See Wheeler*, 2002 UT 16 at ¶ 20.

In particular, Angel sought discovery regarding the basis for the testimony provided in the nineteen affidavits, Brief of Appellant, Addendum E at ¶ 7, the knowledge of Defendants' misconduct by other minority interest owners, *id.* at ¶ 8, the percentage of ownership interest of each of the nineteen affiants, *id.* at ¶ 10, and the extent of ownership within the company, *id.* at ¶ 14. As explained in Angel's opening

Brief and in greater detail below, these facts regarding the ownership interests and motivations of the other Xango owners are relevant to the question of whether there are any similarly situated minority owners, and this discovery would have revealed that Angel is a "class of one." Thus the requested discovery was directly relevant to the issue of whether Angel is a fair and adequate representative with standing under Rule 23.1.

The district court therefore committed reversible error when it granted the motion to dismiss and considered evidence outside the pleadings without first allowing Angel to conduct discovery necessary to rebut that evidence and effectively respond to the motion to dismiss.

III. THE DISTRICT COURT ERRED IN GRANTING THE MOTION TO DISMISS BASED ON ITS DETERMINATION THAT ANGEL DID NOT SATISFY THE "FAIR AND ADEQUATE REPRESENTATIVE" REQUIREMENT OF RULE 23.1

The district court based its conclusion that Angel is not a fair and adequate representative under Rule 23.1 on two grounds, both of which were improper grounds for dismissal. First, the district court erred in concluding that Angel is not a "class of one" and therefore cannot proceed as a derivative plaintiff without the support of other XanGo members. Second, even if Angel is not a class of one and other XanGo members are similarly situated to Angel, the district court erred in granting the motion to dismiss based only on a purely hypothetical conflict between Angel's interests in the Direct Lawsuit and its interests in the Derivative Lawsuit.

A. The District Court Erred in Concluding that Angel is Not a Class of One and Cannot Proceed Without the Support of Other XanGo Members

The district court erred in granting the motion to dismiss based on the lack of support for the derivative action from other Xango members. At the heart of this issue is the question of what it means to be "similarly situated" as required by Rule 23.1. According to Defendants and the district court, at least four of the other Xango minority members are automatically similarly situated to Angel if they would benefit financially from the Derivative Suit[1]. *See* Brief of Appellee at 17-23; Brief of Appellant, Addendum A at 7, 11. This is an erroneous – and ultimately unfair – interpretation of Rule 23.1.

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[1] Defendants allege that Angel mischaracterized the district court's Ruling when it said that the district court "eliminated" from its consideration any affidavits filed by the Defendants, relatives of the Defendants, or employees of XanGo. Brief of Appellees at 17-18 (arguing that the district court did not "eliminate" any particular XanGo member and actually held that "even if" these affiants are excluded, "at least" four other XanGo members are similarly situated to Angel). This is a matter of semantics.

In its Ruling, the district court stated:

> In this case, the evidence before the court shows that six of the nineteen affiants are the Defendants and two have a family relationship with a Defendant. As of September 30, 2006, the Defendants owned 86.1% of XanGo. Seven other affiants are employees of XanGo. **Only four** of the affiants do not have an employee or family relationship to the Defendants or the company of which Defendants are majority owners. **While Defendants, their family members, and the XanGo employees may not be similarly situated to Plaintiff, the Court finds that the four remaining affiants are similarly situated to Plaintiff.**

Brief of Appellant, Addendum A at 11 (emphasis added). Whether or not the district court formally "eliminated" any particular XanGo member from its consideration is irrelevant; the fact remains that the district court chose not to include the Defendants, relatives of the Defendants, and employees of XanGo in its finding of similarly situated XanGo members.

In reality, the determination of whether shareholders or members are similarly situated is much broader than that, incorporating other considerations such as the characteristics of the shareholders' or members' ownership interests, voting rights, management status, relationships with the defendants or current management, and motivations for opposing the derivative suit.

Defendants allege that the cases upon with Angel relies, such as *Jordon v. Bowman Apple Prods. Co.* and *Larson v. Dumke,* actually support Defendants' limited definition of "similarly situated" rather than Angel's broader considerations. *See* Brief of Appellees at 18. This is not true. Neither *Jordon* nor *Larson* supports the position that a "similarly situated" determination is based solely on who would benefit from the derivative claims.

In *Jordon* the court considered the other shareholders' ownership interests and voting rights in determining whether any shareholders were similarly situated to the derivative plaintiff. While the derivative plaintiff in *Jordon* may (or may not) have been the only party who would benefit from the derivative claims, the court did not rely on or even mention this criteria when it determined that the derivative plaintiff had standing as a "class of one" under Rule 23.1. Instead, the court in *Jordon* emphasized that in a case such as the case before it where oppression and mismanagement were alleged, the existence of any stock voting arrangement which alters the power structure of the corporation is "[c]learly important." *Jordon v. Bowman Apple Prods. Co.*, 728 F. Supp. 409, 413 (W.D. Va. 1990). Because the derivative plaintiff in that case was the only shareholder who had not entered into a voting-trust agreement which gave voting control

of the stock to the corporate president, the court concluded that no other shareholders were similarly situated and the derivative plaintiff was a legitimate class of one. *Id.*

More important, in *Larson*, the court considered the other shareholders' relationship with the defendants as well as their motivation in opposing the derivative suit. While the derivative plaintiff in *Larson* may (or may not) have been the only party who would benefit from the derivative claims, the court did not rely on or even mention this criteria when it determined that the derivative plaintiff had standing as a "class of one" under Rule 23.1. Instead, the court emphasized that in that case, the non-defendant shareholders were not similarly situated with the derivative plaintiff because they had an economic interest in supporting the current management and because their opposition to the derivative suit may have been "motivated by individual interests, rather than the good of the corporation." *Larson v. Dumke*, 900 F.2d 1363, 1368 (9th Cir. 1990).

Angel's situation is strikingly similar to the situations in *Jordon* and *Larson*. Here, the district court found that four XanGo minority members were similarly situated to Angel, and all but one of those members have entered into an operating agreement which Angel alleges (in the Direct Suit) has been used to oppress Angel and mismanage corporate assets. R.238 at 7-8. Some members, such as the Grimmers, also have a board position and special status with some management control, while another, the Bederra Group, has economic status as a XanGo vendor. R.238 at 7-8.

While Genesis Group has allegedly not signed the 2005 Amended and Restated Operating Agreement, it is not similarly situated to Angel because it has indicated its desire, along with the other minority owners, to allow the misfeasance in the company to

continue in perpetuity. Moreover, Genesis Group was once a supporter of Angels' efforts and actually helped finance the Direct Lawsuit before being threatened by XanGo. R.211-12, ¶¶6-7. Genesis Group apparently changed its mind with regard to the derivative action and the Direct Lawsuit when it signed an affidavit stating that it did not agree with the legal actions being taken by Angel. Angel was prevented from exploring through discovery Genesis' reasons for now disagreeing with the actions Angel has taken to enforce its minority interests. Angel should have been given the chance to conduct discovery on these material facts. As a result, each of these XanGo members has a shared economic interest with the Defendants and thus a personal motivation for opposing the Derivative Suit.

Despite Defendants' assertions to the contrary, this situation is not similar to that in *Smith v. Ayres*, where the court held the plaintiff could not proceed as a class of one because the other owners opposing the derivative action "simply fundamentally disagree[d] with [the proposed derivative plaintiff] on what is good for the corporation." 977 F.3d 946, 949 (5th Cir. 1992). Here, the XanGo members who oppose the Derivative Suit do so not because of a fundamental disagreement with Angel about what is best for the company, but because of their desire to protect their own economic interests. It would be in the company's best interests to put an end to the malfeasance, but as the district court noted in its Ruling, the affidavits submitted by the other XanGo members indicate that the other members "have clearly determined that even if the alleged malfeasance is

occurring, they prefer to allow its continuance rather than allow XanGo to be involved in a derivative lawsuit."[2] Brief of Appellant, Addendum A at 11.

Because the other XanGo members are motivated by their own interests and willing to go along with the controlling members' malfeasance, they are not similarly situated to Angel and it would not be in XanGo's best interests to require Angel to fairly and adequately represent them. *See Kuzmickey v. Dunmore Corp.*, 420 F. Supp. 226, 231 (E.D. Pa. 1976) ("[T]here are no other shareholders who are 'similarly situated,' *viz.*, shareholders who are dissatisfied with the actions of the officers and directors of [the corporation]."); *see also Brandon v. Brandon Constr. Co.*, 776 S.W.2d 349, 351 (Ark. 1989) ("The mere fact that the other shareholders were willing to go along with a violation of the rights of the corporation did not foreclose the [plaintiff] from maintaining her action.").

Angel is unique because of its continued opposition to the operating agreement, because it alone has no economic interest in supporting the Defendants or current XanGo management, and because it alone wants to put a stop to the XanGo management's malfeasance. If Angel cannot proceed as the derivative plaintiff in this action, XanGo

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[2] In their Statement of Fact ¶ 8, Defendants quote this relevant language from each affidavit. Brief of Appellees at 9. Notably, Defendants acknowledge that this language is nearly identical in eighteen of the nineteen affidavits, which only strengthens Angel's argument that it must be allowed to proceed as a class of one. Eighteen separate affiants would not just spontaneously choose the same language to express their opinions regarding the Derivative Suit, and this similarity in the affidavits only supports Angel's suspicions that the other Xango members are being controlled or influenced in some way by Xango management. There is obviously some entanglement here which Angel should have been allowed to discover.

will be left without a remedy. *See Halsted Video, Inc. v. Guttillo*, 115 F.R.D. 177, 180 (N.D. Ill. 1987) (concluding that the derivative plaintiff could proceed as a class of one and noting that to accept defendants' argument to the contrary would leave not only the derivative plaintiff but also the company without a remedy for the defendants' alleged misconduct); *Eye Site, Inc. v. Blackburn*, 796 S.W.2d 160, 162 (Tex. 1990) (discussing this reasoning from *Halsted*).

As the only XanGo member seeking to protect the company's interests, Angel should be allowed to proceed in the Derivative Suit as a class of one. To hold otherwise – that is, to hold that a sole dissenting member cannot bring a derivative action on behalf of the entity against the controlling members – would violate a significant principle of corporate governance. For policy reasons, minority members must have the ability to challenge oppressive and wrongful conduct on the part of the majority members, regardless of how unpopular the suit may be from the perspective of other members.[3]

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[3] Defendants also attempt to draw this Court's attention to the fact that Angel owns only 1% of Xango in comparison to the nineteen remaining members, who own 99%. *See* Brief of Appellees at 33-34. It is deceiving to consider the ownership interests of both the controlling members and the minority members together, however, and separating the two groups reveals that the relevant ownership interests are not quite as disparate as Defendants would make them seem.

As controlling members, the six Defendants alone account for at least 86 percent of the Xango ownership. R.238 at vi; Brief of Appellant, Addendum E at ¶ 12. The remaining thirteen minority members own only 14 percent of Xango, with respective ownership percentages ranging from .10 percent to 3.3 percent. Brief of Appellant, Addendum E at ¶ 12. Thus, all of the minority members own percentages of XanGo which are comparable to the 1 percent owned by Angel. There is no great disparity between Angel's ownership percentage and the ownership percentages of those minority members who oppose the Derivative Suit.

Furthermore, the cases relied on by Defendants do not support the argument that the ownership percentage of those who oppose the derivative action is dispositive. For

The district court erred when it determined that Angel is not a fair and adequate representative and cannot proceed as a class of one pursuant to Rule 23.1 and therefore committed reversible error in granting the motion to dismiss on this ground.

B. The District Court Erred in Determining that Angel is an Inadequate Representative under Rule 23.1 Based on a Hypothetical Conflict

The district court erred in determining that Angel is an inadequate representative and in granting the motion to dismiss because it failed to first find that an actual conflict existed between Angel's interests in the Direct Suit and its interests in the Derivative Suit. Although Defendants do not address the issue of this failure in their Appellees' Brief, this failure is critical and requires that the district court's Ruling be reversed.

The law is clear that in order to dismiss a derivative plaintiff based on a conflict of interest, the court must first find that the plaintiff has interests that are actually – not

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example, while it is true that in *Nolen* 79 of the 84 stockholders (representing 96 percent of the outstanding stock) opposed the derivative action, the Sixth Circuit recognized the difficulty of applying a quantitative requirement to a Rule 23.1 standing determination and expressly stated that it would not affirm on that ground. *Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 508 & n.4 (6th Cir. 1971).

Kuzmickey is also distinguishable. In that case, the defendants and other minority shareholders together owned 84 percent of the corporation (70 and 14 percent, respectively), and the potential derivative plaintiff owned only 16 percent. Even though the court in *Kuzmickey* found that the potential plaintiff was an inadequate representative under Rule 23.1, it did so based on its erroneous conclusion that a derivative plaintiff could not ever proceed as a class of one – not because of the plaintiff's relatively small ownership. *See Kuzmickey v. Dunmore Corp.*, 420 F. Supp. 226, 231 (E.D. Pa. 1976); *see also Eye Site, Inc. v. Blackburn*, 796 F. Supp. 160, 161-162 (Tex. 1990) (citing cases and recognizing that more recent decisions have expressly rejected the *Kuzmickey* interpretation of Rule 23.1). The *Kuzmickey* court found that no other shareholders were similarly situated with the potential derivative plaintiff, and thus, under the correct interpretation of Rule 23.1, the derivative action would not have been dismissed. The plaintiff in *Kuzmickey* would have been allowed to proceed as a class of one, regardless of its ownership percentage.

merely potentially – antagonistic to the other shareholders in the derivative action. *Vanderbilt v. Geo-Energy, Ltd.*, 725 F.2d 204, 207 (3d Cir. 1983). Conflicts which are merely hypothetical possibilities are insufficient to support dismissal of a derivative action. *G.A. Enterprises, Inc. v. Leisure Living Communities, Inc.*, 517 F.2d 24, 27 (1st Cir. 1975); *Williams v. Service Corp. Int'l*, 459 S.E.2d 621, 622 (Ga. Ct. App. 1999); 7C Fed. Prac. & Proc. Civ. 3d § 1983; *see In re Transocean Tender Offer Securities Litig.*, 455 F. Supp. 999, 1014 (D.C. Ill. 1978) (allowing a derivative plaintiff to proceed where "at this stage of the proceedings there is merely a potential conflict of interest present"). The district court itself even recognized in its Ruling that "[i]f only a potential conflict is present, the cases may both proceed; the Court may take appropriate action if an actual conflict arises." Brief of Appellant, Addendum A at 9.

Despite the district court's recognition of this clear requirement, however, it dismissed the Derivative Suit based only on a finding of a potential conflict. In its Ruling, the district court found only that "there **may be** some actual conflict between [Angel's] interest in the Direct Lawsuit and its representation in the derivative suit," and even acknowledged that it is "**possible"** that Angel's participation in the Direct Suit **will not** decrease its interest in pursuing the derivative claims. Brief of Appellant, Addendum A at 9 (emphasis added). Because of this failure to find that an actual conflict of interest exists, the district court's determination that Angel is an inadequate representative under Rule 23.1 and dismissal of the Derivative Suit must be reversed. *See Vanderbilt*, 725 F.2d at 208-209 (reversing the dismissal of a derivative action based on a determination that the plaintiff was an inadequate representative where the district court issued its order

without first finding that the plaintiff's interest were antagonistic to those of the other shareholders).

Furthermore, even had the district court made such a finding, the dismissal of the Derivative Suit would still be reversible error because there is no actual conflict of interest. As Defendants recognize, there is no *per se* rule against simultaneous direct and derivative actions, *see in re Transocean Tender Offer Securities Litig.*, 455 F. Supp. at 1014, and derivative claims seeking monetary damages on behalf of the corporation are not incompatible with direct claims seeking dissolution of the corporation.

While the court in *Neusteter v. District Court* did not formally address the requirements of Rule 23.1 in relation to the plaintiffs dissolution claim,[4] the court nevertheless offered helpful guidance explaining that derivative claims and claims for dissolution do not create an unavoidable conflict of interest. The court explained that the defendants' argument that derivative claims are "good" for the corporation while dissolution claims are "bad" for the corporation "extends the anthropomorphic concept of the corporation – a person capable of injury and knowledge – beyond the point of its usefulness in solving problems involving corporate relationships." *Neusteter*, 675 P.2d 1, 8 (Colo. 1984). Instead, the court concluded that both remedies are ultimately directed at protecting investments, and there is "no contradiction" between a plaintiff's derivative

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[4] The court did address the issue of fair and adequate representation under Rule 23.1, however, analyzing whether the plaintiffs were required to adequately represent the very persons charged with wrongdoing, or only the "similarly situated" members of the allegedly wronged minority group. *Neusteter*, 675 P.2d at 7.

action and concurrent claim for dissolution because of the prospect of continued mismanagement of the corporation. *Id.*

GLFP, Ltd. v. CL Management, Ltd., also supports the position that there is no conflict of interest between derivative claims and claims for dissolution. In that case, the Utah Court of Appeals concluded that the plaintiff's allegations set forth a sufficient basis – separate and apart from the derivative claims – for seeking judicial dissolution. *GLFP*, 2007 UT App. 131, ¶ 13, 163 P.3d 636. While Defendants are correct that the court in *GLFP* did not specifically address the issue of standing under Rule 23.1, the court did reverse summary judgment on the dissolution claim and indicated that a derivative claim for breach of fiduciary duty can co-exist with a direct claim for dissolution.[5] *GLFP*, 2007 UT App. 131 at ¶¶ 12-13, 15.

Defendants urge this Court to rely upon *Read v. Read,* a Wisconsin case which Defendants assert stands for the proposition that a conflict of interest exists when a derivative plaintiff moves in a direct suit to dissolve the corporation. *See* Brief of Appellees at 28. In *Read*, the Wisconsin Court of Appeals did affirm the dismissal of a derivative action where the derivative plaintiff also sought dissolution of the corporation.

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[5] This is particularly true in light of the fact that an appellate court can affirm a district court's ruling for "any reason supported by the record," even if that reason differs from the stated basis for the ruling below. *See U.S. v. Hanson*, 526 F.3d 653, 663 (10th Cir. 2008); *Wilson v. Titan Indem. Co.*, 508 F.3d 971, 975 n.3 (10th Cir. 2007).

In *GLFP*, had the Utah Court of Appeals believed that a direct claim for dissolution of a corporation is fundamentally incompatible with derivative claims, it was free to affirm the dismissal of the dissolution claim on that ground. But it did not. It elected instead to reverse the trial court's grant of summary judgment on that claim. *GLFP*, 2007 UT App. 131, ¶¶ 12-13.

The problem with relying on *Read*, however, is that the Wisconsin statute upon which the court's reasoning is based differs significantly from Rule 23.1.

Under the Wisconsin statute, in order for a shareholder to have standing to bring a derivative action, he or she must "[f]airly and adequately represent the **interests of the corporation** in enforcing the right of the corporation." *Read*, 556 N.W.2d 768, 771 (Wis. App. 1996) (emphasis added). The Wisconsin court recognized that there is a "notable difference" between Wisconsin's statute and Fed. R. Civ. P. 23.1 (and thus also Utah's Rule 23.1), which requires instead that a derivative plaintiff "represent the **interests of the shareholders or members similarly situated** in enforcing the right of the corporation." *Id.*

Because under Wisconsin law the court was required to find that the derivative plaintiff adequately represented the corporation, and not any similarly situated shareholders, the trial court dismissed the derivative action, stating that "[i]t is hard to conceive of any way in which dissolution would be beneficial to the corporation in this case." *Id.* at 772. And the appellate court affirmed, indicating that the result may have been different under the federal rule (and thus also Utah's rule) by noting that "[a]lthough a corporation's interests are not served by dissolution, a shareholder's interests might be." *Id.*

As Angel explained in its opening Brief, the dissolution sought in this case could serve the other XanGo members' interests in conjunction with the derivative claims. If Angel succeeds on the derivative fiduciary duty claim, the Defendant will have to pay

damages to XanGo and these damages would then be paid out to all members during the "winding up" phase after dissolution.

The burden is on the defendant to prove that the plaintiff is an inadequate representative under Rule 23.1, *LeVanger*, 2003 UT App. 377 at ¶ 18, and in this case the Defendants have failed to show that there is an actual conflict of interest between Angel's Derivative Suit and the direct claim for dissolution. All the Defendants have done is point out that it is possible to have a conflict of interest between derivative claims and direct claims for dissolution; the Defendants have completely failed to identify anything specific about Angel's motivation in bringing the Direct Suit or about XanGo's circumstances that would indicate any conflict exists. In fact, Defendants presented the district court with only the unsupported allegation that Angel is pursuing the Derivative Suit for the purpose of gaining leverage against XanGo in the Direct Suit, and as a result, the district court refused to make a finding about Angel's motives. Brief of Appellant, Addendum A at 9.

Because the district court did not, and could not, find that an actual conflict exists between the Derivative Suit and the claim for dissolution in the Direct Suit, the court erred in granting the motion to dismiss on this ground.

IV. THERE ARE NO OTHER ALTERNATIVE GROUNDS WHICH WOULD SUPPORT THE DISTRICT COURT'S DETERMINATION REGARDING ANGEL'S STANDING UNDER RULE 23.1

Contrary to Defendants' assertion, there are no alternative grounds which would support the district court's determination regarding Angel's standing under Rule 23.1 or which would be appropriate for this Court to consider on appeal. Defendants assert that

there are other "outside entanglements" and "conflicts of interest" which the district court could have considered, including (1) Angel's non-membership in Xango, (2) the fact that Angel has not signed the operating agreement, and (3) the relatively small benefit that would inure to Angel if the derivative claims were proven. Brief of Appellee at 37-39. None of these factors would have supported the district court's decision, however, nor are any of these factors appropriate justifications for affirming the district court on appeal.

First, Angel's alleged non-membership in XanGo is not an appropriate consideration for this Court on appeal. The district court ruled from the bench in the Direct Suit that there are factual issues regarding whether Angel is a member of XanGo, and no additional evidence or argument was presented to the district court in the Derivative Suit. The district court therefore made no finding as to Angel's membership and expressly refused to grant the motion to dismiss based on the argument that Angel is not a member of XanGo. Brief of Appellant, Addendum A at 6. With no fact finding below, this Court cannot use Angel's membership status as a grounds for affirming the district court. *LeVanger v. Highland Estates Properties Owners Assoc.*, 2003 UT App. 377, 80 P.3d 569, 574 n.5 (the appellate court is limited to the findings of fact made by the trial court and may not find new facts or reweigh the evidence in light of new legal theories or alternative grounds).

Second, the fact that Angel has not signed the operating agreement does not support the district court's decision and is not a justification for affirming on appeal. Although Angel admits that it has not signed the operating agreement, the district court did not rely on this fact in making its determination that Angel lacks standing under Rule

23.1. Defendants do not explain how this fact constitutes an "outside entanglement" or "conflict of interest" which would support the district court's determination, or even why this fact is relevant to the issue of whether Angel could be a fair and adequate representative. All the Defendants offer by way of argument is the unsupported assertion that Angel's "refusal to sign an operating agreement with XanGo is a factor to be considered in this Court's determination." Brief of Appellee at 37. If anything, the fact that Angel has not signed the operating agreement supports Angel's argument that it is a legitimate class of one.

Finally, even assuming Angel's benefit from the derivative claims would be relatively small, this fact does not support the district court's decision and is not a justification for affirming on appeal. The cases upon which Defendants rely, *G.A. Enterprises, Inc. v. Leisure Living Communities, Inc.* and *Rothenberg v. Security Management Co.*, do not support the proposition that whether a proposed derivative plaintiff is an adequate representative is determined based on this size of the plaintiff's stake in the derivative action.

In *G.A. Enterprises*, for example, the court's holding was based not on the size of the plaintiff's stake in the derivative action but on evidence indicating that the derivative action would be used as leverage in other litigation. While it is true that the plaintiff in that case owned less than 1 percent interest in the company and only $2 million was at stake in the derivative action, this is not the reason the First Circuit affirmed the dismissal of the derivative action. Instead, the court affirmed the dismissal because it concluded that an "obvious conflict of interest" was created by the "wide-ranging" legal disputes

between the defendant and the plaintiff's principal, and that plaintiff's stake in the derivative action was outweighed by the magnitude of the principal's outside interests in this other litigation. *G.A. Enterprises*, 517 F.2d 24, 25-26 (1st Cir. 1975) (commenting that "[i]n these circumstances, the court could conclude that the dog might soon wag the tail"). The court held that the plaintiff's (or at least the principal's) outside interests suggested that the derivative suit would be used as a weapon, "to be either pursued, de-emphasized, or settled as the future course of the larger claims might dictate." *Id.* at 26 .

Similarly, in *Rothenberg*, the Eleventh Circuit affirmed dismissal of the derivative action not because of the size of the plaintiff's stake in the derivative action, but because the proposed derivative plaintiff "lacked any understanding of the nature of the derivative suit and displayed an unwillingness to learn." *Rothenberg*, 667 F.2d 958, 962 (11th Cir. 1982). While the plaintiff did hold only about 2% interest in the company and was unlikely to receive anything from a damages award, the court was concerned about this relatively small stake only because in that case, it resulted in the plaintiff's lack of commitment to the action. *Id.* The court based its holding on the fact that throughout the litigation, the plaintiff "remained unaware of the facts and issues involved in the derivative suit" and even "acknowledged that her lack of personal knowledge made her an inappropriate plaintiff to maintain the suit."[6] *Id.*

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[6] Notably, the district court in *Rothenberg* had also been concerned about the possibility of the derivative suit being used as leverage. The court determined that any recovery in the derivative suit would "pale' in comparison to the possibility of recovery in the suit the plaintiff had filed as an individual, and there existed a possibility that the derivative suit would be used as leverage in order to obtain a favorable settlement in the other actions. *Rothenberg*, 667 F.2d at 960. Following the dismissal of the derivative

The situation here is entirely different from the situations in *G.A. Enterprises* and *Rothenberg*. As discussed above, here the district court made no finding of an actual conflict of interest such as the one that existed in *G.A. Enterprises*, and there is no evidence indicating that Angel would use the Derivative Suit to gain leverage against Xango in the Direct Suit. In fact, the district court rejected that argument below and refused to make a finding regarding Angel's motives based solely on allegations of the parties. Brief of Appellant, Addendum A at 9. There is also no evidence indicating that Angel lacks personal knowledge of or commitment to the Derivative Suit, as the plaintiff did in *Rothenberg*. In fact, the district court specifically held that this factor was not in dispute, explaining that "[n]either party asserts than an entity other than Plaintiff is the driving force behind this litigation, nor does either party suggest that Plaintiff or Plaintiff's attorneys are unfamiliar with this litigation." Brief of Appellant, Addendum A at 8.

In the end, this argument concerning the size of Angel's stake in the Derivative Suit simply illustrates that Defendants have it all wrong. The true beneficiary of a derivative claim is the corporation, not the plaintiff, and thus the critical question is not whether Angel would receive any benefit from the Derivative Suit, but whether XanGo would benefit from the Derivative Suit. Because Angel is the only minority member willing to represent XanGo in the derivative claims, and the only way XanGo can benefit

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suit but before oral argument on the appeal, however, the district court directed a verdict in favor of the defendants in the suit filed by the plaintiff as an individual. *Id.* at 961. Thus, any danger that the derivative action would be used as leverage was eliminated, and the Eleventh Circuit did not affirm on that ground. *Id.*

from the derivative action and end the malfeasance that is occurring is if Angel is allowed to proceed as plaintiff. If the Derivative Suit is dismissed, XanGo would be left without a remedy for the Defendants' alleged misconduct.

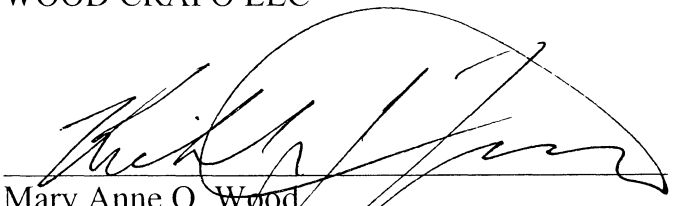
The district court erred in determining that Angel is not a fair and adequate representative in the derivative action and committed reversible error in granting the motion to dismiss on this ground.

CONCLUSION

For the foregoing reasons, this Court should reverse the District Court's Order granting Appellees' motion to dismiss under Rule 12(b)(1).

DATED this 13th day of August, 2008.

WOOD CRAPO LLC



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CERTIFICATE OF MAILING

I certify that on the 13th of August, 2008, I caused two true and correct copies of the foregoing ***REPLY BRIEF OF APPELLANT***, as well as a CD containing a searchable PDF version of the Brief pursuant to Utah Supreme Court Standing Order No. 8, to be mailed in the U.S. Mail, first class postage prepaid to the following:

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